

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

TD 9272

RIN 1545-BE81

REMIC Residual Interests--Accounting for REMIC Net Income (Including Any Excess Inclusions) (Foreign Holders)

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains temporary regulations relating to income that is associated with a residual interest in a Real Estate Mortgage Investment Conduit (REMIC) and that is allocated through certain entities to foreign persons who have invested in those entities. The regulations accelerate the time when income is recognized for withholding tax purposes to conform to the timing of income recognition for general income tax purposes. The foreign persons covered by these regulations include partners in domestic partnerships, shareholders of real estate investment trusts, shareholders of regulated investment companies, participants in common trust funds, and patrons of subchapter T cooperatives. These regulations are necessary to prevent inappropriate avoidance of current income tax liability by foreign persons to whom income from REMIC residual interests is allocated. The regulations clarify the timing of income under section 860G for purposes of determining a domestic partnership's responsibility under sections 1441 and 1442 for withholding tax with respect to a foreign partner's share of REMIC net income as a result of indirectly holding a residual interest.

The regulations also provide that an excess inclusion is treated as income from sources within the United States. The text of the temporary regulations also serves as the text of the proposed regulations set forth in the notice of proposed rulemaking on this subject in the Proposed Rules section in this issue of the **Federal Register**.

DATES: Effective Date: These regulations are effective August 1, 2006.

Applicability Dates: For dates of applicability, see ' ' 1.860A-1T(b)(5), 1.863-1T(f) and 1.1441-2T(f).

FOR FURTHER INFORMATION CONTACT: Dale Collinson, (202) 622-3900 (not a toll-free number).

Background and Explanation of Provisions

This document contains amendments to 26 CFR part 1 under sections 860A, 860G(b), 863, 1441, and 1442 of the Internal Revenue Code (Code). Under section 860C(a)(1), in general, a holder of a REMIC residual interest must take into account the holder's daily portion of the taxable income or net loss of the REMIC for each day of the taxable year on which the holder held the interest. Thus, a residual interest holder generally is taxable currently on the taxable income or net loss of the REMIC without regard to whether or when the REMIC makes distributions.

Section 860G(b) provides an exception to this general rule in section 860C for the timing of income attributable to the ownership of a REMIC residual interest. Under this exception, for purposes of sections 871(a), 881, 1441, and 1442, if amounts are includible in the income of a holder of a REMIC residual interest that is a nonresident alien individual or a foreign corporation, the amounts are taken into account only when paid or distributed to the foreign holder, or when the interest is disposed of.

In its earlier years, a REMIC may accrue and recognize more taxable interest income from the mortgages that it holds than it accrues and deducts as interest on the regular interests that it has issued. This produces net income for the REMIC and thus for the holder of the REMIC's residual interest. Many REMICs are structured so that the REMIC uses all, or substantially all, of its cash flow to pay expenses and to pay principal and interest on regular interests (effectively using a portion of interest receipts to pay principal or other nondeductible items). Such a REMIC will make little or no distributions to the holders of the residual interest in the REMIC, and each holder will incur tax liabilities with respect to its share of the REMIC's net income in an amount that exceeds the holder's economic return.

In addition, all or substantially all of the income attributable to holding the residual interest will be subject to special rules relating to excess inclusions. To ensure that the income will be taxable in all events, these rules, among other things, prevent the use of net operating losses to offset the excess inclusions, see section 860E, and preclude any exemption from, or reduction in, applicable withholding taxes, see section 860G(b)(2). Residual interests that entitle the holder to little or no distributions are commonly referred to as noneconomic REMIC residual interests, and persons acquiring those interests receive an inducement fee for becoming the holder and undertaking the associated tax payment responsibilities. Taxable income that must be recognized in excess of the economic income for a period is often called phantom income. In the case of a REMIC, the early phantom income is generally offset by matching deductions (generally called phantom losses) in later periods.

Consistent with the Congressional purpose of ensuring that excess inclusions of REMICs be subject to tax, ' 1.860E-1(c) of the Income Tax Regulations provides for disregarding transfers of noneconomic REMIC residual interests if a significant purpose of the transfer is avoiding assessment or collection of tax. In addition, ' 1.860G-3(a)(1) provides, "A transfer of a residual interest that has tax avoidance potential is disregarded for all Federal income tax purposes if the transferee is a foreign person." Section 1.860G-3(a)(2) provides, "A residual interest has tax avoidance potential . . . unless, at the time of the transfer, the transferor reasonably expects that, for each excess inclusion, the REMIC will distribute to the transferee residual interest holder an amount that will equal at least 30 percent of the excess inclusion, and that each such amount will be distributed at or after the time at which the excess inclusion accrues and not later than the close of the calendar year following the calendar year of accrual." Accordingly, foreign persons are generally precluded from becoming the direct holders of noneconomic residual interests.

"Where necessary or appropriate to prevent the avoidance of tax imposed by [chapter 1 of the Code]," section 860G(b) authorizes the adoption of regulations requiring REMIC net income inclusions of foreign holders of REMIC residual interests to be taken into account for purposes of sections 871(a), 881, 1441, and 1442 earlier than is provided in section 860G(b)(1). The legislative history of the Tax Reform Act of 1986 indicates that Congress intended that this regulatory authority may be exercised with respect to noneconomic residual interests. See 2 H.R. Rep. No. 841, 99th Cong., 2d Sess. II-236 (1986) (referring to residual interests that do "not have significant value").

The IRS and Treasury Department have become aware that noneconomic REMIC residual interests are being transferred to domestic partnerships that subsequently allocate the phantom income to foreign persons. If a partnership has no foreign partners at the time the partnership acquires a noneconomic REMIC residual interest, the person transferring the residual interest to the partnership may take the position that neither ' 1.860E-1(c) nor ' 1.860G-3 is applicable. In turn, the partnership may take the position, by applying the aggregate approach to the relation between a partnership and its partners, that foreign persons who later become partners hold the REMIC residual interest that had previously been acquired by the partnership. Based on the conclusion that the foreign partners are holders of the residual interest, the partnership may take the further position that, under section 860G(b), a withholding tax obligation on the partnership's allocation to the foreign partner of income from the residual interest arises no sooner than the time when distributions on the residual interest are made by the REMIC (distributions that will almost never occur with a noneconomic residual) or when the interest is disposed of. Under this view, the foreign holder's tax liability with respect to net income of the REMIC (including excess inclusions) would be deferred until disposition of the holder's interest in the REMIC residual interest, including a disposition through termination of the REMIC , a disposition of the REMIC residual interest by the partnership, or a disposition of the partnership interest by the foreign partner.

The IRS and Treasury Department have concluded that, in order to achieve effective assessment and collection of U.S. tax on REMIC net income, including excess inclusion income, in furtherance of the congressional purpose referenced above and

section 860E(a)(1), (b), and (e) and section 860G(b) of the Code, the time when foreign partners are required to account for REMIC net income should be accelerated. That is, for purposes of sections 871(a), 881, 1441, and 1442, the temporary regulations eliminate the deferral (relative to section 860C) that section 860G(b)(1) might otherwise prescribe. To prevent the adoption of similar schemes using real estate investment trusts, regulated investment companies, common trust funds, or subchapter T cooperative organizations, foreign persons to whom excess inclusion income is allocated by any of these other entities must account for REMIC excess inclusions on a similarly accelerated basis.

Several provisions of regulations under sections 1441 and 1442 are relevant to the taxation of REMIC net income inclusions (and particularly net income inclusions with respect to noneconomic REMIC residual interests) that are allocated to foreign persons. Under ' 1.1441-2(e), for purposes of section 1441 and 1442, a payment generally is considered made to a person if that person realizes income, whether or not the income results from an actual transfer of cash or other property. Under ' 1.1441-2(d)(1), however, if a withholding agent is not related to the recipient or beneficial owner, the withholding agent has an obligation to withhold only to the extent that, at any time between the date that the obligation to withhold would arise but for the provisions of ' 1.1441-2(d) and the due date for the filing of a return on Form 1042, "Annual Withholding Tax Return for U.S. Source Income of Foreign Persons," (including extensions) for the year in which the payment occurs, the withholding agent has control over, or custody of money or property owned by the recipient or beneficial owner from which to withhold an amount and has knowledge of the facts that give rise to the

payment. For this purpose, a withholding agent is related to the recipient or beneficial owner if it is related within the meaning of section 482. Section 1.1441-2(d)(1) further provides that the foregoing exception does not apply to distributions with respect to stock or if the lack of control or custody of money or property owned by the recipient or beneficial owner from which to withhold is part of a prearranged plan known to the withholding agent to avoid withholding under sections 1441, 1442, or 1443.”

Under §1.1441-5(b)(2), a U.S. partnership is required to withhold under §1.1441-1 as a withholding agent on an amount subject to withholding (as defined in §1.1441-2(a)) that is includible in the gross income of a partner that is a foreign person. Except as provided in §1.1441-5(b)(2)(v) (which prevents a second withholding obligation from arising with respect to the actual distribution of income previously withheld upon as a distribution from a U.S. partnership or trust), a U.S. partnership is required to withhold when making any distributions that include amounts subject to withholding. To the extent a foreign partner's distributive share of income subject to withholding has not actually been distributed to the foreign partner, the U.S. partnership must withhold on the foreign partner's distributive share of the income on the earlier of the date that the statement on Form 1065, “U.S. Return of Partnership Income,” is mailed (or otherwise provided) to the partner or the due date for furnishing that statement.

Pursuant to the authority granted under section 860G(b), for purposes of sections 871(a), 881, 1441, and 1442, these temporary regulations generally require a foreign partner in a partnership holding one or more REMIC residual interests to take into account REMIC net income inclusions at the end of its taxable year (or on the last date of the taxable year of a partnership that allocates REMIC net income to the foreign

partner). The temporary regulations require a foreign shareholder in a real estate investment trust or regulated investment company, a foreign participant in a common trust fund, or a foreign patron of a subchapter T cooperative organization to take into account excess inclusion income at the same time as other income from the entity.

The temporary regulations also provide that an excess inclusion is treated as income from sources within the United States. The Treasury Department and the IRS believe this treatment is appropriate because the inclusions are largely phantom income arising from the special provisions of the Code relating to REMICs and thus are unlikely to have tax significance outside the United States. The temporary regulations provide that, to the extent excess inclusions are taken into account with respect to a residual interest, net losses with respect to the residual interest are allocated and apportioned to the class and grouping(s) of gross income to which the excess inclusions were assigned.

The temporary regulations also provide that the exemption available under certain circumstances to certain withholding agents that do not have custody or control of money or property from which to satisfy a withholding obligation is not available in any case with respect to an excess inclusion subject to these rules. No inference is intended as to whether, for purposes of this exemption, any right, obligation, contract, or arrangement other than a REMIC residual interest constitutes property of a sort from which a withholding obligation may be satisfied.

Effective Date

The regulations regarding the timing of REMIC income inclusions apply to REMIC net income of a foreign person with respect to REMIC residual interests with respect to which the first REMIC net income allocation to the foreign person under section 860C occurs on or after August 1, 2006. The regulations regarding the source of excess inclusions are applicable for taxable years ending after August 1, 2006.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. These regulations are necessary to provide taxpayers with immediate guidance to discourage the overly aggressive interpretations being employed for the inappropriate avoidance of current income tax assessment or collection by foreign persons who are allocated income from REMIC residual interests. Accordingly, good cause is found for dispensing with notice and public comment pursuant to 5 U.S.C. 553(b)(B), and with a delayed effective date pursuant to 5 U.S.C. 553(d). For the applicability of the Regulatory Flexibility Act (5 U.S.C. chapter 6) refer to the special analysis section of the preamble to the cross-referenced notice of proposed rulemaking published in the Proposed Rules section in this issue of the **Federal Register**. Pursuant to section 7805(f) of Code, these temporary regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is Dale Collinson, Office of the Associate Chief Counsel (Financial Institutions and Products). However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding entries in numerical order to read, in part, as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.860A-1 also issued under 26 U.S.C. 860G(b) and 860G(e).

Section 1.860A-1T also issued under 26 U.S.C. 860G(b) and 860G(e). * * *

Section 1.860G-3T also issued under 26 U.S.C. 860G(b) and 860G(e). * * *

Par. 2. Section 1.860A-0 is amended as follows:

1. Section 1.860A-1, paragraph (b)(5) is added.
2. Section 1.860A-1T is added.
3. Section 1.860G-3, paragraph (b) is revised.
4. Section 1.860G-3T is added.

The additions and revisions read as follows:

§1.860A-0 Outline of REMIC provisions.

* * * * *

§1.860A-1 Effective dates and transition rules.

* * * * *

(b) * * *

(5) [Reserved].

§1.860A-1T Effective dates and transition rules (temporary).

(a) through (b)(4) [Reserved].

(5) Accounting for REMIC net income of foreign persons.

* * * * *

§1.860G-3 Treatment of foreign persons.

* * * * *

(b) Accounting for REMIC net income. [Reserved].

§1.860G-3T Treatment of foreign persons (temporary).

(a) [Reserved].

(b) Accounting for REMIC net income.

(1) Allocation of partnership income to a foreign partner.

(2) Excess inclusion income allocated by certain pass-through entities to a foreign person.

Par. 3. In §1.860A-1 paragraph (b)(5) is added to read as follows:

§1.860A-1 Effective dates and transition rules.

* * * * *

(b) * * *

(5) [Reserved]. For further guidance, see §1.860A-1T(b)(5).

Par. 4. Section 1.860A-1T is added to read as follows:

§1.860A-1T Effective dates and transition rules (temporary).

(a) through (b)(4) [Reserved]. For further guidance, see §1.860A-1(a) through (b)(4).

(5) Accounting for REMIC net income of foreign persons. Section 1.860G-3T(b) is applicable to REMIC net income (including excess inclusions) of a foreign person with respect to a REMIC residual interest if the first net income allocation under

section 860C(a)(1) to the foreign person with respect to that interest occurs on or after August 1, 2006. This section will expire July 31, 2009.

Par. 5. In §1.860G-3, paragraph (b) is revised as follows:

§1.860G-3 Treatment of foreign persons.

* * * * *

(b) Accounting for REMIC net income. [Reserved]. For further guidance, see §1.860G-3T(b).

Par. 6. Section 1.860G-3T is added to read as follows:

§1.860G-3T Treatment of foreign persons (temporary).

(a) [Reserved]. For further guidance, see §1.860G-3(a).

(b) Accounting for REMIC net income--(1) Allocation of partnership income to a foreign partner. A domestic partnership shall separately state its allocable share of REMIC taxable income or net loss in accordance with §1.702-1(a)(8). If a domestic partnership allocates all or some portion of its allocable share of REMIC taxable income to a partner that is a foreign person, the amount allocated to the foreign partner shall be taken into account by the foreign partner for purposes of sections 871(a), 881, 1441, and 1442 as if that amount were received on the last day of the partnership's taxable year, except to the extent that some or all of the amount is required to be taken into account by the foreign partner at an earlier time under section 860G(b) as a result of a distribution by the partnership to the foreign partner or a disposition of the foreign partner's indirect interest in the REMIC residual interest. A disposition in whole or in part of the foreign partner's indirect interest in the REMIC residual interest may occur as a result of a termination of the REMIC, a disposition of the partnership's residual interest in

the REMIC, a disposition of the foreign partner's interest in the partnership, or any other reduction in the foreign partner's allocable share of the portion of the REMIC net income or deduction allocated to the partnership. See §1.871-14(d)(2) for the treatment of interest received on a regular or residual interest in a REMIC. For a partnership's withholding obligations with respect to excess inclusion amounts described in this paragraph (b)(1), see §1.1441-2T(b)(5), §1.1441-2T(d)(4), §1.1441-5(b)(2)(i)(A) and §1.1446-1 through 1.1446-7.

(2) Excess inclusion income allocated by certain pass-through entities to a foreign person. If an amount is allocated under section 860E(d)(1) to a foreign person that is a shareholder of a real estate investment trust or a regulated investment company, a participant in a common trust fund, or a patron of an organization to which part I of subchapter T applies and if the amount so allocated is governed by section 860E(d)(2) (treating it "as an excess inclusion with respect to a residual interest held by" the taxpayer), the amount shall be taken into account for purposes of sections 871(a), 881, 1441, and 1442 at the same time as the time prescribed for other income of the shareholder, participant, or patron from the trust, company, fund, or organization.

Par. 7. Section 1.863-0 table of contents is amended as follows:

1. The entries for §1.863-1(e) are revised.
2. Entries for §1.863-1T are added.

The revisions and additions read as follows:

§1.863-0 Table of contents.

* * * * *

§1.863-1 Allocation of gross income under section 863(a).

* * * * *

- (e) Residual interest in a REMIC.
 - (1) REMIC inducement fees.
 - (2) Excess inclusion income and net losses.
- * * * * *

§1.863-1T Allocation of gross income under section 863(a).

- (a) through (d) [Reserved].
- (e) Residual interest in a REMIC.
- (1) REMIC inducement fees.
- (2) Excess inclusion income and net losses.
- (f) Effective date.

Par. 8. Section 1.863-1 is amended as follows:

1. The paragraph heading for paragraph (e) is revised.
2. The text of paragraph (e) is redesignated as (e)(1).
3. A new paragraph heading for paragraph (e)(1) is added.
4. A new paragraph (e)(2) is added.
5. The last sentence of paragraph (f) is revised and a new sentence is added to

the end.

The revisions and additions read as follows:

§1.863-1 Allocation of gross income under section 863(a).

* * * * *

(e) Residual interest in a REMIC--(1) REMIC inducement fees. * * *

(2) Excess inclusion income and net losses. [Reserved]. For further guidance, see§1.863-1T(e)(2).

(f) * * * Paragraph (e)(1) of this section is applicable for taxable years ending on or after May 11, 2004. For further guidance, see §1.863-1T(f).

Par. 9. Section 1.863-1T is added to read as follows:

§1.863-1T Allocation of gross income under section 863(a) (temporary).

(a) through (d) [Reserved]. For further guidance, see §1.863-1(a) through (d).

(e) Residual interest in a REMIC--(1) REMIC inducement fees. [Reserved]. For further guidance, see §1.863-1(e)(1).

(2) Excess inclusion income and net losses. An excess inclusion (as defined in section 860E(c)) shall be treated as income from sources within the United States. To the extent of excess inclusion income previously taken into account with respect to a residual interest (reduced by net losses previously taken into account under this paragraph), a net loss (described in section 860C(b)(2)) with respect to the residual interest shall be allocated to the class of gross income and apportioned to the statutory grouping(s) or residual grouping of gross income to which the excess inclusion income was assigned.

(f) Effective date. Paragraph (e)(2) of this section applies for taxable years ending after August 1, 2006. For further guidance, see §1.863-1(f). This section will expire July 31, 2009.

Par. 10. Section 1.1441-0 is amended by adding entries for §§1.1441-2(b)(5), 1.1441-2(d)(4), and 1.1441-2T to read as follows:

§1.1441-0 Outline of regulation provisions for section 1441.

* * * * *

§1.1441-2 Amounts subject to withholding.

* * * * *

(b) * * *

(5) REMIC residual interests.

* * * * *

(d) * * *

(4) Withholding exemption inapplicable.

* * * * *

§1.1441-2T Amounts subject to withholding.

- (a) through (b)(4) [Reserved].
- (5) REMIC residual interests.
- (c) through (d)(3) [Reserved].
- (d)(4) Withholding exemption inapplicable.
- (e) [Reserved]
- (f) Effective date.

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Par. 11. Section 1.1441-2 is amended by adding paragraphs (b)(5) and (d)(4), and a sentence to the end of paragraph (f), to read as follows:

§1.1441-2 Amounts subject to withholding.

* * * * *

(b) * * *

(5) REMIC residual interest. [Reserved]. For further guidance, see§1.1441-2T(b)(5).

* * * * *

(d) * * *

(4) Withholding exemption inapplicable. For further guidance, see §1.1441-2T(d)(4).

* * * * *

(f) * * * For further guidance, see§1.1441-2T(f).

Par. 12. Section 1.1441-2T is added to read as follows:

§1.1441-2T Amounts subject to withholding (temporary).

(a) through (b)(4) [Reserved]. For further guidance, see§1.1441-2(a) through (b)(4).

(5) REMIC residual interests. Amounts subject to withholding include an excess inclusion described in §1.860G-3T(b)(2) and the portion of an amount described in §1.860G-3T(b)(1) that is an excess inclusion.

(c) through (d)(3) [Reserved]. For further guidance, see §1.1441-2 (c) through (d)(3).

(4) Withholding exemption inapplicable. The exemption in §1.1441-2(d) from the obligation to withhold shall not apply to amounts described in §1.860G-3T(b)(1) (regarding certain partnership allocations of REMIC net income with respect to a REMIC residual interest).

(e) [Reserved]. For further guidance, see §1.1441-2(e).

(f) Effective date. This section applies after August 1, 2006. This section will expire July 31, 2009.

Mark E. Matthews,
Deputy Commissioner for Services and Enforcement.

Approved: July 14, 2006

Eric Solomon,
Acting Deputy Assistant Secretary of the Treasury